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No. 99-1295

In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Tenth Circuit

BRIEF FOR THE PETITIONERS

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QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation which obtained a discharge of indebtedness. Income with respect to this cancellation of debt ("COD") was excluded from gross income under 26 U.S.C. § 108(a). The question presented in this case is whether excluded COD income is an item of income within the meaning of 26 U.S.C. § 1366(a)(1)(A), which increases Petitioners' basis in their S corporation stock pursuant to 26 U.S.C. § 1367.

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I. LOWER COURT OPINIONS

The United States Tax Court issued an initial opinion on June 24, 1997, reported at T.C.M. (RIA) 97,286. App. 25.[1] Subsequently, that opinion was withdrawn, and the Tax Court issued a revised opinion, which was filed on February 19, 1998 and reported at T.C.M. (RIA) 98,071. App. 21. The Tenth Circuit affirmed the Tax Court in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999). App. 1.

II. JURISDICTION

The Commissioner of the Internal Revenue issued Notices of Deficiency to Petitioners Gitlitz and Winn who timely petitioned the Tax Court to review the proposed deficiencies. App. 59 and App. 75. The Tax Court had jurisdiction under §§ 6212, 6213, 6214, and 7442 of the Internal Revenue Code (Title 26).[2] The Petitioners filed timely notices of appeal on April 27, 1998. The Tenth Circuit's jurisdiction arose under § 7482(a)(1). The Tenth Circuit's decision was entered on July 6, 1999, and Petitioners' Petition for Rehearing was denied on November 3, 1999. App. 32. The Petitioners Petition for Writ of Certiorari was timely filed on February 1, 2000 and granted by this Court, which has jurisdiction pursuant to 28 U.S.C. § 1254(1).

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[1] Citations to "App." refer to the Appendix attached to Petitioners' Petition for Writ of Certiorari.

[2] All subsequent citations to the "Code" refer to the Internal Revenue Code of 1986, Title 26 of the United States Code. All statutory citations, unless otherwise specified, refer to that Title. Citations to Regulations or Treasury Regulations refer to 26 C.F.R.

III. STATUTORY AND REGULATORY PROVISIONS INVOLVED

Sections 108, 1366, and 1367 of the Code are set forth at App. 34, App. 52, and App. 56, respectively. Subsections (a) through (d) of § 1.1367-1 of the Treasury Regulations are set out in the Appendix to this brief (Merits Brief Appendix or "MBA") at MBA:1.

IV. STATEMENT OF THE CASE

The facts are not in dispute, and are described in the parties' cross motions for summary judgment filed with the Tax Court. Documents Nos. 6, 7, 8, 12, and 13 in Tax Court Docket Nos. 5359-96 (Winn) and 5358-96 (Gitlitz).[3] Petitioners David Gitlitz and Philip Winn (collectively, with their spouses, the "Taxpayers") were shareholders of P.D.W.&A., Inc. ("PDW&A"), a corporation which had elected to be taxed pursuant to Subchapter S of the Code. In 1991, PDW&A realized cancellation of debt ("COD") income in the amount of $2,021,296. At the time, PDW&A was insolvent to the extent of $2,181,748. Sections 108(a)(1)(B) and 108(d)(7)(A) permitted PDW&A to exclude the entire amount of the cancelled indebtedness from its gross income.

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[3] The filed briefs and motions in the two Tax Court cases (*Gitlitz v. Commissioner*, Tax Court Docket No. 5389-96, and *Winn v. Commissioner*, Tax Court Docket No. 5358-96) were virtually identical (only the names differed) and the pleadings have identical docket numbers. The cases were ultimately consolidated for purposes of briefing. For convenience, the term "Document No." refers to the records (identical) in both Tax Court cases.

Subchapter S of the Code (26 U.S.C. § 1361 *et seq.*) allows shareholders of qualifying corporations to elect a "passthrough" system of taxation. Under this system, income, losses, deductions, and credits of the corporation "pass through" and are directly attributed to the shareholders. *Bufferd v. Commissioner*, 506 U.S. 523, 525 (1993). With some specific exceptions, income, expenses, and other tax-related items realized by an S corporation are passed through to the corporation's individual shareholders in a manner that is similar to the tax treatment of partnerships. *Compare* §§ 1366 and 1367 *with* §§ 704 and 705. Under this passthrough system of taxation, income is subjected to only a single level of taxation.[4] The shareholders report on personal tax returns their *pro rata* share of S corporation income, irrespective of whether there was any actual distribution of money to the shareholder. If an item of income is taken into account when determining the shareholder's taxable income, the shareholder's basis in his or her stock in the S corporation is increased by that amount. §§ 1366(a) and 1367(a). Items of income that are not subject to tax, such as municipal bond interest, are likewise added to a shareholder's basis, provided such income items could have an effect upon a shareholder's tax liability.

Corporate losses and deductions are also passed through to the shareholder. However, a shareholder cannot take corporate losses and deductions into account on his or her personal tax return to the extent that such

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[4] This passthrough system differs significantly from the Code rules governing ordinary C corporations, where the corporation pays income tax on corporate income under § 11, and the individual shareholders pay tax on distributions. § 61(a)(7); §§ 301-307.

items exceed basis. § 1366(d)(1). If corporate losses and deductions allocated to the shareholder exceed basis, the losses do not disappear, but are suspended until shareholder basis is sufficiently large to permit the deduction. §§ 1366(d)(1) and 1366(d)(2).

An increased basis resulting from corporate income realized during the year permits the shareholder to take additional corporate deductions or losses (including losses suspended in previous years) on their personal returns, or, alternatively, to receive distributions from the corporation without paying tax. §§ 1366-1368. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶¶ 6.06[4] – 6.06[5] (6th ed. 1998).

On their tax returns, the Taxpayers increased their shareholder basis in the PDW&A stock by the amount of their pro rata share of PDW&A's excluded COD income ($1,010,648). This increased basis permitted the Taxpayers to deduct on their personal returns corporate losses and deductions previously allocated to the Taxpayers, but which were suspended under § 1366(d) because the losses exceeded the Taxpayers' basis in their PDW&A stock.

The Commissioner disallowed the deduction of the additional losses, asserting that the shareholder basis increase for excluded COD income was improper under the statutes. The Taxpayers sought redetermination of the Commissioner's proposed deficiencies in the Tax Court.

In the Tax Court, the parties filed cross motions for summary judgment. At oral argument, the Commissioner departed from his contentions on brief. Relying upon Treas. Reg. § 1.61-12(b), the Commissioner argued that

COD income is not an "item of income" within the meaning of §§ 1366 and 1367 because the income is not "realized." Apparently confident that the Tax Court would hold that excluded COD income was not an "item of income," counsel for the Commissioner stated "if the Court finds that excluded COD is an item of income, either tax exempt or otherwise, then we're squarely within Code section 1366, and the basis consequences would flow." (Document No. 20 at p.31).

On June 24, 1997, the Tax Court issued its opinion in *Winn v. Commissioner*, T.C.M. (RIA) 97,286. In that opinion, the Tax Court stated:

> In memoranda filed with the court prior to the hearing on these matters, several arguments were set forth in support of respondent's motions, including the argument that discharge of indebtedness income was 'deferred' and not 'tax exempt income' under § 1366(a) . . . . At the hearing on these matters, however, respondent abandoned those prior arguments and argued the following position:
>
> > If the court were to hold that excluded COD (cancellation (discharge) of indebtedness) is an item of income under § 1366, then you would have to find that it flows through to the taxpayers and they increase their basis. Respondent's position is that it's not an item of income and never flows through. . . .
>
> We deal here solely with respondent's 'final' position.

The Tax Court issued an opinion in favor of the Taxpayers, holding that COD income is an "item of income" within the meaning of § 1366. The Commissioner thereafter filed a motion for reconsideration, arguing that he had not intended to abandon any of the arguments

presented in his memoranda, and that his counsel had merely presented a "new alternative argument." Document No. 24 at p. 2.

The Tax Court granted reconsideration after the issuance of its opinion in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999). *Winn v. Commissioner*, T.C.M. (RIA) 98,071, App. 21. In *Nelson*, the Tax Court held, contrary to the Commissioner's "final position" in *Winn*, that §§ 1366 and 1367 do not control the shareholder stock basis consequences of an S corporation's realization of excluded COD income. Instead, the Tax Court held that § 108 contains a specific provision which overrides the Subchapter S passthrough rules. That provision, § 108(d)(7)(A), requires that certain aspects of § 108 (e.g., determination of insolvency, amount of exclusion, attribute reduction) be "applied at the corporate level" in the case of S corporations.[5] The Tax Court construed the "applied at the corporate level" language to preclude treating excluded COD income as an item of income which is taken into account at the shareholder level pursuant to §§ 1366 and 1367. *Nelson*, 110 T.C. at 121. The Tax Court also concluded that excluded COD income was not "tax-exempt income," which would increase basis under §§ 1366(a)(1)(A) and 1367(a), but was actually "tax deferred income," because the COD income was related to attribute reduction that would result in increased income in the future. *Nelson*, 110 T.C. at 125.

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[5] Section 108(d)(7)(A) provides that, in the case of S corporations, subsections (a), (b), (c), and (g) of § 108 are to be "applied at the corporate level." Section 108(a)(1)(B) provides for an exclusion from income to the extent of insolvency.

The Tenth Circuit specifically rejected the Tax Court's primary holding in *Nelson*, i.e., that the "applied at the corporate level" language of § 108(d)(7)(A) prevented excluded COD income from being taken into account for purposes of §§ 1366 and 1367. *Gitlitz*, 182 F.3d at 1148. However, the Tenth Circuit ruled for the Commissioner on an alternate ground, holding that excluded COD income is eliminated in its entirety at the S corporation level in the process of attribute reduction under § 108(b), prior to the time that the passthrough of excluded COD income would result in a basis increase. *Gitlitz*, 182 F.3d at 1148-1150.

Section 108(b) requires that certain tax attributes be reduced by the amount of COD income excluded under § 108(a). Section 108(d)(7)(B) provides that shareholder losses in excess of basis, suspended under § 1366(d), are treated as a tax attribute subject to reduction. This reduction is supposed to be made "after the determination of tax for the taxable year of the discharge." § 108(b)(4)(A). In this case, if the reduction in shareholder suspended losses were made subsequent to the year of the discharge, the excluded COD income would have been taken into account, and would have increased basis, allowing the passthrough of additional losses in the year of the discharge.

The Tenth Circuit concluded that the issue is one of timing, i.e., whether the amount of excluded COD income is to be applied to reduce suspended losses before it passes through and is taken into account for basis purposes under §§ 1366 and 1367. The Tenth Circuit considered the matter a "close question." It reasoned, however, that an interpretation permitting passthrough prior to attribute reduction would result in a "windfall" to the

Taxpayers. It therefore held that attribute reduction should more appropriately occur in the year of the discharge, not in the subsequent year. The Tenth Circuit concluded that the excluded COD income should be eliminated prior to passthrough by virtue of being "applied against" the Taxpayers' suspended losses. The court also held that income in excess of attributes is disregarded, and does not pass through. *Gitlitz*, 182 F.3d at 1147.

V. SUMMARY OF ARGUMENT

The Taxpayers filed their 1991 tax returns in accordance with the specific and detailed rules set forth in §§ 1366 and 1367. These two provisions, and these two provisions alone, expressly govern the S corporation shareholders' determination of stock basis, which in turn effects the amount of S corporation losses which the shareholder is entitled to claim as a deduction on his or her individual income tax return. These rules state unequivocally that all items of income, including tax-exempt income, increase stock basis, provided that separately taking an item into account could affect any shareholder's tax liability.

The Treasury Regulation interpreting § 1367 is equally clear. It specifically provides that "nontaxable income," i.e., items that are excluded from the S corporation's current year's income and therefore are similarly excluded by the shareholder in determining his or her taxable income, are nonetheless taken into account by the shareholder through an increase in stock basis. Neither §§ 1366 and 1367, nor the regulations interpreting those sections, suggest that excluded COD income is to be treated any differently for shareholder stock basis purposes than any other nontaxable item of income realized

by the S corporation, but excluded from the calculation of taxable income.

Municipal bond interest is excluded from gross income under § 103, but is taken into account by the shareholder and added to his or her stock basis because, in the words of § 1366, the separate treatment of this item "could affect the tax liability of [a] shareholder." The effect that tax-exempt bond interest could have upon shareholder tax liability, since it is not included in the current year's income, is through an increase in shareholder basis. By adding this item to basis, the shareholder is able to deduct additional losses flowing from the S corporation, and potentially eliminate tax resulting from a distribution of assets to the shareholder or a sale of the shareholder's stock. The same potential consequences for shareholder tax liability are present in the case of nontaxable COD income. In addition, excluded COD income could affect each shareholder's tax liability by reducing the shareholder's nondeductible suspended losses, pursuant to the "attribute reduction" provisions of §§ 108(b) and 108(d)(7)(B).

In short, the only sections of the Code that control the determination of shareholder stock basis, §§ 1366 and 1367, are unambiguous. They require that excluded COD income must be taken into account by the shareholder and added to his or her stock basis. Nothing in § 108 provides to the contrary. In fact, § 108 does not mention S corporation shareholder stock basis, let alone provide any special rules for the treatment of excluded S corporation COD income for shareholder stock basis purposes.

Nevertheless, since the Tax Court issued its initial opinion in *Winn*, holding that COD income is an item of income which passes through to the shareholder for stock

basis purposes under §§ 1366 and 1367, the focus of the Tax Court, and then the Tenth Circuit, has been upon § 108, not upon §§ 1366 and 1367. This reflects an effort to avoid the result the Tax Court reached in its initial opinion, where the focus of the court was more properly upon §§ 1366 and 1367. Both courts have in essence rewritten § 108 in an effort to achieve the result which they wanted to obtain.

First, the Tax Court in *Nelson* interpreted § 108(d)(7)(A) and the statutory language providing that the exclusion under § 108 is to "be applied at the corporate level" to mean that COD income cannot be taken into account at the shareholder level. The short answer to that position is that *all* S corporation nontaxable income is initially attributed to the corporation and excluded at the corporate level because it is the corporation that realizes the income, not the shareholder. And, §§ 1366 and 1367 require that all corporate income items be taken into account for purposes of calculating shareholder stock basis. Every appellate court to consider the issue, including the Tenth Circuit in this case, has concluded that the Tax Court's reliance upon § 108(d)(7)(A) was misplaced.

The Tenth Circuit adopted an entirely new rationale urged by the Justice Department. It concluded that § 108(d)(7)(B) required that shareholders' suspended losses be "added to the corporation's net operating losses." Then, before the losses "pass through" to the shareholder, they must be reduced by the amount of excluded COD income as part of the attribute reduction process. The Tenth Circuit held that the attribute reduction process eliminated entirely both the COD income, which the Taxpayers sought to add to their stock basis,

and the additional losses, which the Taxpayers claimed as a result of this increased basis.

The Tenth Circuit's rationale flies in the face of at least two provisions of § 108. First, § 108(d)(7)(B) does not state that shareholder losses in excess of stock basis (before taking into account COD income) are to be treated as corporate net operating losses ("NOLs") and reduced by excluded COD income. Instead, the section says that "any loss or deduction ***which is disallowed for the taxable year of the discharge*** under section 1366(d)(1)" (emphasis supplied) is to be treated as a corporate NOL subject to reduction by the amount of the excluded COD income. Section 1366(d)(1), the provision that limits shareholder loss deductions to shareholder basis, in turn, requires that the calculation of disallowed loss be made only *after* all adjustments to basis under § 1367(a) for the taxable year are computed.

Thus, *before* the attribute reduction can take place, §§ 108(d)(7)(B) and 1366(d)(1) mandate that the shareholder must determine (1) his or her stock basis, and (2) his or her loss, if any, in excess of stock basis. Step (1) requires that a pro rata share of all items of S corporation income for the taxable year, including COD income, be added to shareholder basis. Applying the mandate of the statute to the facts of this case, first, the shareholder basis is increased by excluded COD income. Then, the disallowed net loss for the year is determined. This approach results in a significantly reduced loss "disallowed for the taxable year of the discharge under § 1366(d)(1)" subject to reduction under § 108(d)(7)(B).

Not only did the Tenth Circuit fail to give any operative effect to the express language of § 108(d)(7)(B), but it also essentially wrote § 108(b)(4)(A) out of the Code.

Section 108(b)(4)(A) expressly provides that attribute reduction takes place *after* the determination of tax for the taxable year of the discharge. The Tenth Circuit in essence held that § 108(b)(4)(A) does not mean what it says, and concluded that suspended losses are reduced *during* the taxable year of the discharge, and prior to the pass-through of COD income.

A careful analysis of the three statutes, §§ 108, 1366, and 1367, leads to the reporting position which these and many other taxpayers adopted on their tax returns. The Tenth Circuit concluded that the Taxpayers claimed "the equivalent of a double deduction," in that the Taxpayers did not pay tax on the discharge of debt, and then claimed deductions for suspended losses by reason of a basis increase resulting from the debt relief. In fact, the tax benefits claimed by the Taxpayers do not differ from and are no greater than those afforded by the Code to all other S corporation shareholders whose corporations have nontaxable income and suspended losses: the income is excluded from tax, basis is increased, and the use of otherwise suspended losses is permitted.

Even if the result were considered a "windfall," that does not justify the liberties taken with the controlling statutory language at issue: the Tax Court and the Tenth Circuit both added limitations that do not exist in the Code or the regulations and simply struck operative language from the statutes. The statutes must be interpreted as written, particularly in the absence of any regulation or published ruling stating that the interpretation adopted by the Taxpayers on their returns was incorrect.

Taxpayers already have the difficult task of finding and following the complicated and cumbersome rules of the Code and the Treasury Regulations. Taxpayers should

not have to shoulder the additional risk that, even if they follow those rules to the letter, the tax consequences they claim may be set aside if the Commissioner later decides the consequences were too generous to the taxpayer.

VI. ARGUMENT

A. Excluded COD Income Is An Item Of Income That Increases Shareholder Basis Under §§ 1366 And 1367.

1. Excluded COD Income Is An "Item Of Income."

The primary issue in this case is whether the excluded COD income of an S corporation is taken into account as an item of income by shareholders in their calculation of basis. The statute governing S corporation shareholder basis provides that shareholder stock basis for the S corporation's taxable year is increased by the items of income described in subparagraph (A) of § 1366(a)(1). § 1367(a)(1)(A). Section 1366(a)(1)(A) in turn provides that a shareholder shall take into account the shareholder's pro rata share of the corporation's "items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder."

To resolve the question as to whether or not the excluded COD income of the corporation is properly taken into account by the shareholder, it is necessary to determine whether excluded COD income is an "item of income" for purposes of § 1366(a)(1)(A). That question was correctly resolved by the Tax Court in its first *Winn* opinion, where the Court stated:

> Section 61 requires that certain amounts be included in income, i.e., items of income. Specifically, section 61(a)(12) requires that discharge of indebtedness be included in gross income. Absent any exclusionary provision, items of income are included in gross income. Sec. 61(a). Sections 101 through 135 exclude specific items of income from gross income. Discharge of indebtedness income to the extent of insolvency is one of the items so excluded. Sec. 108(a)(1)(A), (3).
>
> Based upon the foregoing, we hold that discharge of indebtedness is an "item of income" for purposes of determining a shareholder's basis in S corporation stock by its inclusion in the definition of gross income under section 61(a)(12).

Winn v. Commissioner, T.C.M. (RIA), 97,286, *withdrawn and reissued as* T.C.M. (RIA) 98,071. Although the *Winn* opinion was withdrawn, neither the reissued *Winn* opinion, nor the *Nelson* opinion, disputed that excluded COD income was an "item of income," but reasoned that the item remained at the corporate level, and was not passed through. Every Circuit to examine the issue has likewise considered excluded COD income as an "item of income." *United States v. Farley*, 202 F.3d 198, 209-210 (3d Cir. 2000); *Pugh v. Commissioner*, 2000 WL 718215 at *5 (11th Cir. 2000); *Witzel v. Commissioner*, 200 F.3d 496, 498 (7th Cir. 2000); and *Gaudiano v. Commissioner*, 2000 WL 748179 at *10 (6th Cir. 2000); *See also Hogue v. United States*, 2000 WL 2651 at *2, 85 A.F.T.R.2d 2000-426 (D.Ore. 2000),

The exclusion of COD income from gross income does not prevent its inclusion as a corporate "item of income" which increases shareholder basis. Congress

made this principle clear when it specifically referred to "tax-exempt income" as being included within the broad reach of corporate "items of income" that effect basis under §§ 1366 and 1367. Congress, moreover, did not limit the items to be added to shareholder basis to those that were "taxable" or "tax-exempt." Instead, it required each and every item realized by the S corporation to be added to shareholder basis, provided the item could affect the tax liability of any shareholder.

2. Excluded COD Income "Could Affect" Shareholder Tax Liability Through Basis Adjustments Or Attribute Reduction.

The language "could affect the liability for tax of any shareholder" has a more sweeping reach than "increases or decreases the gross income" of any shareholder. Certainly items of income that are both realized *and* recognized by the corporation directly increase the shareholder's taxable income and consequentially effect his or her tax liability. However, a potential impact upon an individual shareholder's tax liability is also present with "items of income" which are realized but not recognized by the corporation.

Nontaxable income such as state and local bond interest under § 103 and life insurance proceeds under § 101 does not *directly* alter any shareholder's tax liability by increasing his or her gross income. Income treated as nontaxable at the corporate level will not be treated otherwise at the shareholder level. § 1366(b). Thus, the meaning of the phrase "could affect the tax liability of any shareholder," when referring to nontaxable income, necessarily relates to an indirect consequence of having realized the income. One such indirect consequence is the

effect that an asset distribution has upon the tax liability of the receiving shareholder. Congress specifically recognized that a basis increase is necessary in order to protect the nontaxable item from taxation at the shareholder level.[6] *See* S. Rep. No. 640, 97 Cong., 2nd Sess. 16 (1982), 1982-2 C.B. 718, 725; *Pugh*, 2000 WL 718215 at *4. In addition, a basis increase for nontaxable income such as municipal bond interest allows a shareholder to deduct his or her share of S corporation losses suspended under § 1366(d) to the extent of the increase.

The aforementioned indirect consequences of taking the income into account are likewise present with respect to excluded COD income. Moreover, another, equally compelling effect exists as well. Under § 1366(d), where a shareholder's share of S corporation losses and deductions for any taxable year exceeds his or her stock basis, the excess may not be deducted currently, but is "suspended" and carried to future periods for deduction by the shareholder if and when the shareholder obtains sufficient basis. §§ 1366(d)(1) and 1366(d)(2). Section 108(d)(7)(B) provides that, in the case of an S corporation, one of the "tax attributes" subject to reduction under § 108(b) is the aggregate of § 1366(d) suspended losses which the corporation's shareholders possess.

Mechanically, § 108(d)(7)(B) accomplishes this result by providing that shareholder suspended losses are to be treated as if they were net operating losses ("NOLs") for

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[6] A distribution of assets by an S corporation to its shareholder is normally nontaxable to the shareholder to the extent of his or her basis. § 1368. Likewise, the amount of the shareholder's basis potentially affects the amount of gain or loss on the sale of his or her stock. JACOB MERTENS, 11 LAW OF FED. INCOME TAXATION, § 41B:154.

purposes of § 108(b) attribute reduction. NOLs are the first item reduced under § 108(b)(2). Thus, attribute reduction may diminish shareholder-level suspended losses, and ultimately affect the shareholders' tax liability in future years.

As an illustration of how the receipt of COD income may be related to shareholder tax liability, suppose that an S corporation has two shareholders: A, with a stock ownership of 60%, and B, with 40%. A and B each have losses suspended under § 1366(d)(1) in the amounts of $90 and $40, respectively, as of the time of attribute reduction. *See* § 108(b)(4). Assume that the corporation realizes $30 in excluded COD income. It is necessary to reduce the shareholder suspended losses in accordance with the shareholders' pro rata share of the income item when attribute reduction takes place under §§ 108(b)(2)(A) and 108(d)(7)(B). Any other allocation would be arbitrary and unfair. In this illustration, A's suspended losses are reduced by $18 (60% of $30) to $72 and B's suspended losses are reduced by $12 (40% of $30) to $28.

Therefore, it cannot be seriously disputed that excluded COD income "may affect" the tax liability of a shareholder. A potential consequence of the realization of excluded COD is the reduction of shareholder-level suspended losses. This reduction may ultimately result in an increase in the shareholders' tax in subsequent years. As such, excluded COD income must be taken into account by shareholders in the calculation of their stock basis under § 1367(a)(1)(A).

3. The Treasury Regulation Interpreting § 1367 Requires That Nontaxable Income Be Added To Shareholder Basis.

The Treasury Regulations,[7] consistent with the statutes, do not condition a basis increase upon an item being either "taxable" or "tax-exempt." The relevant Treasury Regulation[8] provides that the inclusion of an item of

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[7] The regulations discussed herein are those portions of §§ 1.1367-1 through 1.1367-3 which were finalized in 1994. In 1998 after the *Nelson* opinion was issued by the Tax Court, Treasury released new proposed regulations that made substantial changes to the treatment of COD income under §§ 1366, 1367, and 1368. *See* New § 1.1366-1(a)(2)(viii); 63 Fed. Reg. 44,181-01. These regulations were ultimately finalized in December of 1999. 67 Fed. Reg. 71,641. The new regulations by their terms are effective only for tax years beginning after August 18, 1998. § 1.1366-5.

[8] The regulations under § 1367 discussed herein were first published in proposed form on June 9, 1992 (57 Fed. Reg. 24,426, PS-264-82, 1992-2 C.B. 760), prior to the extended due dates of the Taxpayers' income tax returns. Treasury adopted substantially identical regulations thereafter. 59 Fed. Reg. 12, T.D. 8508, 1994-1 C.B. 219. The Tax Court ignored these regulations (§§ 1.1367-1 through 1.1367-3) in its *Nelson* opinion, stating that no regulations were in effect during the year at issue (1991). *Nelson*, 110 T.C. at 118. While technically correct, the Tax Court's analysis is incomplete. Although these regulations were only directly applicable to tax years after 1993, with respect to pre-1994 years, § 1.1367-3 provides that taxpayer positions must be reasonable, and that taxpayer positions in accordance with the regulations would be treated as reasonable. By essentially renouncing the right to challenge taxpayer positions taken in accordance with the regulations in years prior to the effective date of the regulations, as a practical matter, the Commissioner gave the regulations retroactive effect, at least as a safe harbor. Moreover, Treasury's interpretation of the statute proposed initially in 1992 and well prior to any litigation regarding the

nontaxable income in the shareholder basis computations for the taxable year depends upon whether the item would have been included in income during the year had it been taxable, rather than nontaxable:

> [A basis] adjustment for a ***nontaxable item*** is determined for the taxable year in which the item would have been includable or deductible under the corporation's method of accounting for federal income tax purposes if the item had been subject to federal income taxation.

Treas. Reg. § 1.1367-1(d)(2) (Emphasis supplied.). If the COD income "had been subject to federal income taxation," it would be includable ***only*** in the year of discharge. Under no circumstances would recognition of ***taxable*** COD income be deferred beyond the year of discharge under the corporation's method of accounting.

Nevertheless, the Commissioner has argued that COD income is only "tax-deferred," not "tax-exempt," and therefore is not an item that increases basis under §§ 1366 and 1367.[9] While we dispute that characterization as discussed in Section E of the Argument, the rule for determining whether an item is taken into account or "deferred" for purposes of shareholder basis is clearly set out in Treas. Reg. § 1.1367-1(d)(2). Any argument for deferral must be consistent with the language of that regulation.

The Commissioner's suggestion that excluded COD items which are "nontaxable" in the current taxable year,

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issue involved in this case, stands as persuasive authority as to how the statute should be interpreted.

[9] The Commissioner's argument has been accepted only by the Tax Court in *Nelson*, and not by any of the Circuit Courts to review this issue.

but which might be related to collateral tax consequences in future years, should be treated as a "deferred item," cannot be reconciled with the language of the regulation. This is because the item itself (COD income) is not deferred. The excluded discharge of indebtedness is indisputably realized and would have been "includable [in gross income in the year of receipt] . . . for federal income tax purposes under the corporation's method of accounting" had it been a taxable debt discharge under § 61(a)(12). The COD income item (*qua* item) will never be taken into account in any future year.[10]

The conflict between the Commissioner's postulated "tax deferred" characterization and language of the governing regulation is striking: the regulations require inclusion of ***all*** items, even those that are "nontaxable," if the corporation's method of accounting places the item in the current year.[11] The plain and unqualified language of

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[10] With respect to decreases in stock basis for losses or deductions, in its 1992 transmittal of the proposed regulations that would ultimately be adopted in 1994, Treasury explained that the timing of the basis decrease depended solely upon "the amount of any loss or deduction that is allowed for the taxable year under section 1366(d), regardless of whether the loss or deduction is disallowed or deferred under another provision of the Code, such as the passive loss rules of section 469." 57 Fed. Reg. 24,426, 24,427-24,428. Thus, so long as the placement of the deduction in the current year is correct under § 1366, the fact that certain tax consequences of the deduction are postponed until subsequent years is irrelevant. The same rule should apply for items of income as apply to items of loss or deduction.

[11] When the corporation's method of accounting places an item (or portions thereof) in different taxable years, deferral is appropriate. *See Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 504-506 (1948) (items recognized on the installment method need not be included in C corporation earnings and profits – the

Treas. Reg. § 1.1367-1(d)(2) makes the determination of whether an income item effects basis depend solely upon whether the item would have been includable in gross income under the corporation's method of accounting had the item "been subject to federal income taxation." The Commissioner cannot plausibly claim that the COD income item is more appropriately taken into account in any year other than the year of the discharge.

4. The Legislative History Confirms That Basis Should Be Increased By All "Non-Taxable" Items.

The legislative history of the Subchapter S Revision Act of 1982 uses the term "non-taxable income" in describing the types of income items that will serve to increase basis:

> Under the bill, both taxable and ***non-taxable income*** and deductible and non-deductible expenses ***will serve,*** respectively, ***to increase*** and decrease a Subchapter S ***shareholder's basis*** in the stock of the corporation.

S. Rep. No. 640, 97th Cong., 2d Sess. 18 (1982), 1982-2 C.B. 718, 726 (emphasis supplied). The language of the legislative history, like the regulations, describes a tax world comprised of only "taxable" and "non-taxable" income. Expenses similarly are either "deductible" or "non-deductible." The language of the legislative history recognizes no in-between. There does not exist a "tax limbo" where the government can conveniently hide income

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computation of which is similar to that of shareholder basis in Subchapter S stock – until payments are includable under the corporation's method of accounting).

items that unfortunately conflict with ill-reasoned theories. Congress understood that ***each and every*** item of income, if properly realized in a given year, would increase basis, whether taxable or non-taxable.

Thus, the statute, the regulations, and the legislative history all consistently and without equivocation describe a tax system where COD income realized and properly taken into account by an S corporation in a given year, whether taxable or nontaxable, serves to increase basis. The benefit claimed by the Taxpayers in this case, i.e., an increase to shareholder basis that permits the use of formerly suspended losses, is squarely within the language of the statutes and the Treasury Regulations.

B. The Commissioner And The Courts Have Denied The Taxpayers The Statutory Basis Increase Under A Variety Of Legal Theories.

Notwithstanding the clear language of the statutes, the Commissioner challenged the basis increase taken by the Taxpayers on the grounds that excluded COD income should not pass through to Subchapter S shareholders. The Commissioner's position was first articulated in a 1994 technical advice memorandum. Tech. Adv. Mem. 94-23-003 (June 10, 1994) (the "TAM"). Virtually all of the commentators disagreed with the analysis in the TAM and concluded that the Commissioner's position was without merit.[12] Recognizing the legal and logical flaws

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[12] *See, e.g.*, AICPA, *Pre-Release Comments Regarding Regulations on Discharge of Indebtedness Income under Internal Revenue Code Section 1366*, Apr. 5, 1995 (Reprinted in the BNA DAILY TAX REPORT, April 10, 1995 at G-2); Richard M. Lipton, *IRS Challenges S Corporation Basis Increase for COD Income*, 81 J.TAX'N

in the Commissioner's arguments, these commentators reasoned that the statutory provisions at issue were clear and unambiguous, and that the IRS must seek an amendment to the Code if it wished to alter the results. The Commissioner chose neither to pursue corrective legislation, nor to clarify his position by releasing Treasury Regulations or other published guidance, prior to pursuing a judicial solution.

The Tax Court agreed with the Commissioner that excluded COD income realized by an S corporation cannot be passed through to the shareholders and used to increase the basis in their stock when it issued its opinion in *Nelson*. The Tax Court based its decision on a provision outside Subchapter S, § 108(d)(7)(A). This statute provides that certain subsections of § 108, including the basic exclusion from income of § 108(a), are to be applied "at the corporate level." The Tax Court interpreted this language to override and create an exception to the pass-through rules of §§ 1366 and 1367, and consequently held that excluded COD income was solely a corporate level item that could not be passed through and taken into

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340 (Dec. 1994); Richard M. Lipton, *The Story of the Tortoise and the Hare: Workouts Involving S Corporations*, TAXES, April 1994, p. 163; Richard Gore, *Troubled 'S' Corporation That Recognizes COD Income May Yield Substantial Tax Benefits*, 9 TAX MGMT. REAL EST. J. 80 (Apr. 7, 1993); Brian P. Collins and Mark A. Schneider, *TAM 9423003: The IRS Says Excluded COD Income Does Not Increase S Corporation Stock Basis*, 6 J. OF S CORP. TAX'N. 348; *See also* James S. Eustice, *Financially Distressed S Corporations*, 53 TAX NOTES 97 (1991) (issue first articulated); Fred T. Witt, Jr., *Report of the [ABA] Section 108 Real Estate and Partnership Task Force*, 46 TAX LAW. 209, 234-35 (Prior to issuance of TAM, blue ribbon Task Force concludes applicable law is clear, but a minority suggests that a legislative change should be pursued by the IRS.)

account at the individual level. *Nelson*, 110 T.C. at 121-122.

Commentators were just as critical of this Tax Court holding as they were of the original TAM.[13] The Tenth Circuit in *Gitlitz* likewise found the Tax Court's interpretation of § 108(d)(7)(A) unpersuasive:

> The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that all items of income are attributed initially to the corporation.

Gitlitz, 182 F.3d at 1148. The Tenth Circuit held that such income would pass through to shareholders unless it was absorbed in the attribute reduction process implemented under § 108(b). *Gitlitz*, 182 F.3d at 1148. The Tenth Circuit also held that any excluded COD income not absorbed would be disregarded. *Gitlitz*, 182 F.3d at 1151.

The Third Circuit in *Farley*, 202 F.3d at 209-210, the Eleventh Circuit in *Pugh*, 2000 WL 718215 at *5, the Seventh Circuit in *Witzel*, 200 F.3d at 498, and the Sixth Circuit in *Gaudiano*, 2000 WL 748179 at *10, like *Gitlitz*, rejected the Tax Court's interpretation of § 108(d)(7)(A),

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[13] *See* Jerry S. Williford, *Shareholder is Wrestled Down with a Full Nelson – Interplay of COD and S Corporation Rules*, TAX MANAGEMENT MEMORANDUM (August 3, 1998); Richard M. Lipton, *Tax Court Rejects S Corp. Basis Step-Up for COD Income in Nelson*, 88 J. TAX'N 272 (May 1998); James D. Lockhart and James E. Duffy, *Tax Court Rules in Nelson that S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis*, 25 WM. MITCHELL L. REV. 287 (1999).

and reasoned that excluded COD income constituted an "item of income" for purposes of the § 1366 passthrough and the § 1367 adjustment to basis rules. The *Farley* court, as well as the Oregon district court in *Hogue*, held for the taxpayers, rejecting the *Gitlitz* absorption model as contrary to the statutory scheme. *Farley*, 202 F.3d at 205-206, *Hogue*, 2000 WL 2651 at *3. The *Witzel* and *Gaudiano* courts held for the Commissioner on grounds similar to those set out by the Tenth Circuit in *Gitlitz*, i.e., COD income is absorbed in the attribute reduction process, but reasoned that any income not absorbed should not be disregarded, and would serve to increase basis. *Witzel*, 200 F.3d at 498; *Gaudiano*, 2000 WL 748179 at *10. The *Pugh* court did not have to address the *Gitlitz* absorption rationale, because the taxpayers before it had no attributes, but it did agree with the *Farley* court (and the dicta in *Witzel* and *Gaudiano*) that excluded COD income in excess of attributes is added to basis. *Pugh*, 2000 WL 718215 at *5 n.13.

C. The Tax Court Holding That § 108(d)(7)(A) Created A Special Exception To The General Passthrough Rules Of §§ 1366 And 1367 Is Incorrect.

1. The *Nelson* Court Misinterpreted The Phrase "Applied At The Corporate Level."

In reaching its conclusion, the *Nelson* court overlooked the fundamental rules of Subchapter S that govern the relationship between corporation and shareholder. All items of income and deduction related to activities of the corporation are attributed in the first instance to the corporation, not its shareholders, and the taxable income of an S corporation as an entity is "computed in the same manner as in the case of an individual." § 1363(b). Under

this system, "deductions generally allowable to individuals [are] allowed to subchapter S corporations." S. Rep. No. 640, *supra* at 15, 1982-2 C.B. at 724. Thus, the question as to what extent deductions are "allowable" is ***always*** answered initially at the corporate level. Likewise, income realized by an S corporation is recognized and included in the corporation's taxable income, or is excluded from gross income (if a specific statutory exclusion is implicated) "at the corporate level."

The Tax Court ignored the settled meaning of the phrase "applied at the corporate level." The phrase "applied at the corporate level" has been used in other circumstances by Treasury in connection with S corporations. For example, the hobby loss limitations under § 183 are "applied at the corporate level" in the case of an S corporation. Treas. Reg. § 1.183-1(f). *See also Sousa v. Commissioner*, T.C.M. (RIA) 89,581. The application of the hobby loss limitations at the corporate level does not alter or prevent the S corporation from passing through the ***allowable*** portion of such deduction to the shareholder.[14] The accepted meaning of the phrase is that certain limitations are applied and/or results determined first at the "corporate level" *before* such items are subsequently

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[14] Likewise, the statute governing S corporation audit procedures (former § 6241) during the year at issue provided that the "tax treatment of any subchapter S item shall be **determined at the corporate level**." (emphasis supplied.) Former § 6241 (1995), repealed by P.L. 104-188, § 1307(c)(3)(C). The corporate level adjustments are then passed through as adjustments to the shareholders' individual tax liabilities. *See Twenty-three Nineteen Creekside, Inc. v. Commissioner*, 59 F.3d 130, 133 (9th Cir. 1995) ("Congress provided tax determinations for S corporations would take place at the corporate level, except where the Secretary provided otherwise by regulations.")

passed through and taken into account at the shareholder level.

Since Congress chose to use a phrase ("applied at the corporate level") in § 108(d)(7)(A) that has been used in connection with other S corporation rules and which has a commonly understood meaning in the taxation of S corporations and their shareholders, the interpretation of the phrase in § 108(d)(7)(A) must be consistent with the meaning accorded to the phrase in its other uses. *Commissioner v. Keystone Consol. Industries, Inc.*, 508 U.S. 152, 159 (1993).

2. There Is No Indication That Congress Intended To Create An Exception To The Subchapter S Passthrough Rules When It Enacted § 108(d)(7)(A).

Under the statutory scheme existing prior to the enactment of § 108(d)(7)(A), the determination as to whether an item of COD income was excludable, i.e., the amount of insolvency, was required to be made with respect to each shareholder of the S corporation. P.L. 97-354, § 3(e), amending § 108(d)(6). Section 108(d)(7)(A) changed that rule and applied the insolvency determination "at the corporate level." However, the statutes governing S corporation basis calculation were not changed with the enactment of § 108(d)(7)(A). Nothing in the statutory language or the legislative history pertaining to § 108(d)(7)(A) even hints that Congress intended to alter the rule that all income passes through to shareholders.

The *Nelson* court read § 108(d)(7)(A) as an adjustment or exception to the general S corporation rules embodied in §§ 1366 and 1367, which require the pass through of all income "realized or recognized at the corporate level" by

an S corporation. *Nelson*, 110 T.C. at 120-121. However, if Congress amended the working of §§ 1366 and 1367 through its enactment of § 108(d)(7)(A), it did so solely by implication because the "passthrough rules" were never mentioned in either the statute or legislative history of § 108(d)(7)(A).

The general rule of statutory construction is that "amendments by implication" are disfavored. *United States v. Welden*, 377 U.S. 95, 102 n.12 (1964). When later statutes do not directly address the workings of earlier statutes, the finding of an amendment by implication can only be based on the legislature's clear and manifest intention. *City of Tulsa, Oklahoma v. Midland Valley R. Co.*, 168 F.2d 252, 254 (10th Cir. 1948).

The literal language of § 108(d)(7)(A) does not conflict at all with the provisions of Subchapter S. *Farley*, 202 F.3d at 208-209. Moreover, the lack of any direct reference to shareholder basis adjustments in § 108(d)(7)(A) evidences an ***absence*** of any intention to modify the previously existing S corporation stock basis rules, particularly when one considers the explicit statements regarding shareholder basis adjustments contained in the contemporaneously enacted § 108(d)(7)(C), which addresses adjustments to basis in shareholder loans required in connection with contributions of shareholder indebtedness.

D. The Tenth Circuit's Holding That Discharge Of Indebtedness Income Does Not Pass Through Because It Is Offset By Attribute Reduction Is Contrary To The Plain Language Of The Statutes.

In *Gitlitz*, the Tenth Circuit concluded that an S corporation's COD income does not pass through to shareholders and increase their stock basis because the income is eliminated at the S corporation level where it is "applied against" shareholder suspended losses, which are treated as a "tax attribute" and subject to reduction under § 108(b).

Section 108(b)(1) provides that "the amount [of COD income] excluded from gross income . . . shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." The "tax attributes" potentially subject to reduction under § 108(b)(2) include NOLs for the current year and NOL carryovers from other years, capital loss carryforwards, and basis in property. *See* § 108(b)(2)(A)-(G). In the case of S corporations, which do not have NOLs or NOL carryovers because their annual losses flow through to the shareholder in their entirety (*See* § 1371(b) and Treas. Reg. § 1.172-1(f)), there is a special rule which requires that losses previously allocated to the S corporation's individual shareholders, but suspended because of insufficient shareholder basis under § 1366(d)(1), are to be treated as NOLs for attribute reduction purposes. § 108(d)(7)(B). Shareholder suspended losses under § 1366(d)(1) are the amount by which losses flowing through to the shareholder exceed stock basis. This amount is nondeductible for the current year, but carries forward and can be used as a deduction in subsequent years to the extent that stock basis is

increased. § 1366(d)(2). The rule of § 108(d)(7)(B) operates to reduce shareholder suspended losses in the same manner as C corporation NOLs are reduced.

The Tenth Circuit concluded that the case turned on the timing of the § 108(b) attribute reduction. The Tenth Circuit considered the timing issue "the most difficult aspect of this case," and acknowledged that, if corporate attributes were reduced after the taxable year of the discharge, "the taxpayers' theory must prevail." *Gitlitz*, 182 F.3d at 1148. The Tenth Circuit interpreted the timing statute, § 108(b)(4)(A), to provide for attribute reduction *during*, rather than *after*, the taxable year of discharge, and prior to the required passthrough of all items of S corporation income. However, in order to reach this result, the Tenth Circuit disregarded:

(1) The rules of §§ 108(d)(7)(B) and 1366(d)(1), which require that all items of S corporation income for the year be taken into account at the shareholder level for basis purposes before the amount of the "suspended loss" attribute can be determined; and

(2) The plain language of the statute, which requires that attribute reduction "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." § 108(b)(4)(A).

1. The Tenth Circuit Disregarded The Language Of §§ 108(d)(7)(B) And 1366(d)(1) When It Concluded That Suspended Losses Become Corporate Net Operating Losses Subject To Attribute Reduction Before Excluded COD Income Is Passed Through And Taken Into Account By Shareholders In The Determination Of Their Tax Liability.

In adopting an "absorption" rationale, the Tenth Circuit put the cart before the horse. The "horse," shareholder suspended losses, are an attribute that can only come into existence and be computed *after* the shareholder's basis for the taxable year has been determined under the rules of §§ 1366 and 1367. The "cart," attribute reduction, only comes into play to the extent that shareholder losses exceed basis *after* the excluded COD income item has been added to basis. Sections 108(d)(7)(B) and 1366(d)(1), taken together, leave no room for any other interpretation.

In explaining how it understood COD income to be "absorbed" in the attribute reduction process, the *Gitlitz* court stated that the corporation "first must compute its discharge of indebtedness income and set this figure aside temporarily."[15] *Gitlitz*, 182 F.3d at 1151. Then, the court reasoned that § 108(d)(7)(B) requires that shareholder suspended losses "be added to the corporation's annual net operating losses in applying the net operating loss attribute reduction." *Gitlitz*, 182 F.3d at 1148. The court concluded that this means that before shareholders

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[15] The statutory basis for "temporarily setting aside" COD income until attribute reduction occurs was never explained by either the Commissioner or the Tenth Circuit.

compute their stock basis, (1) the corporation must compute its NOL attribute, which equals the suspended losses of the shareholders from prior years, plus the current year's loss, and (2) the corporation must then apply the COD income against the shareholder suspended losses, eliminating the COD income for passthrough purposes. *Gitlitz*, 182 F.3d at 1151.[16]

The Tenth Circuit failed to recognize that the computation of suspended losses presupposes and requires the passthrough of excluded COD income. In this regard, § 108(d)(7)(B) treats "any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1)," as an attribute subject to reduction under § 108(b). Thus, the taxpayer must first make a determination as to how much loss or deduction is "disallowed" for the taxable year, pursuant to § 1366(d)(1). Section 1366(d)(1), in turn, provides that the disallowed amount is calculated with reference to the shareholders' adjusted basis in their stock "determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year."

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[16] The Tenth Circuit appears to believe that the language of § 108(b)(1), providing that "the amount excluded . . . shall be applied to reduce the tax attributes" meant that the excluded COD income itself was eliminated. This is incorrect: the ***amount*** of the excluded income is just used as the measurement for the amount of attribute reduction. This is a common method for making correlative adjustments under the Code. For example, § 50(c) provides "if [investment] credit is determined . . . , the basis of [investment credit] property shall be reduced by the amount of the credit. . . . " The investment credit itself does not disappear because the amount of the credit is used to reduce basis in the investment credit property.

Therefore, in order to determine the net suspended loss for the year under § 1366(d)(1), shareholders must first calculate their stock basis under § 1367(a)(1), taking into account *all items* of income for the year (including COD income), and then compare this basis amount with all items of loss or deduction (which include previously suspended losses from prior years under § 1366(d)(2)). It is only to the extent that the losses and deductions exceed basis that the shareholder will have a net suspended loss for the year under § 1366(d)(1). Analytically, the calculation of basis under § 1367 is a preliminary computation that must be made logically prior to the determination of the suspended loss for the year under § 1366(d)(1). Only the amount of suspended loss that exceeds the shareholder's basis, which includes the shareholder's pro rata share of ***all*** corporate income for the year, is actually "disallowed for the taxable year of the discharge" under § 1366(d)(1) and, therefore, subject to attribute reduction. The statutory scheme does not permit one to "temporarily set aside" COD income at the corporate level and then calculate suspended losses for the year. Excluded COD income must be taken into account in computing the disallowed losses at the shareholder level under §§ 108(d)(7)(B) and 1366(d)(1).[17]

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[17] An additional problem exists with the Tenth Circuit's analysis that attribute reduction occurs prior to the passthrough of income. The rationale eliminates losses that the corporation's non-COD passthrough income would have allowed. Suppose that a corporation whose shareholders possess $100 in suspended losses receives $100 of ordinary income and $100 of excluded COD income during the year. If attribute reduction occurs before the passthrough of income, the $100 in suspended losses is eliminated, and cannot be used by the shareholders to offset the $100 in ordinary income, because the passthrough of

The Tenth Circuit's application of § 108 to the facts of this case vividly illustrates the flaws in the court's analysis. The court acknowledged that in 1991 the S corporation had approximately $2 million in excluded COD income. Gitlitz and Winn each had more than $1 million in losses, including losses suspended in prior years and losses incurred in 1991. The Tenth Circuit reasoned that the process first required the computation of the NOL attribute subject to reduction, which the court stated equaled the $2 million in losses. But §§ 108(d)(7)(B) and 1366(d)(1) only treats the net loss disallowed for 1991 calculated *after* the adjustments to basis required under §§ 1366 and 1367 as a corporate NOL, subject to attribute reduction. When adjustments to basis were properly made under §§ 1366 and 1367, Gitlitz and Winn each had an additional $1 million in COD income added to basis, against which their losses of $1 million were applied, significantly reducing the net suspended loss for the year which would be available for attribute reduction.

The Taxpayers emphasize that their interpretation of § 108(d)(7)(B) does not preclude suspended losses from ever being reduced as a tax attribute; any losses that are not used after the basis increase for corporate income for the year, and which remain suspended under § 1366(d)(1), are subject to reduction. If Gitlitz and Winn each had $2 million in suspended losses, $1 million of

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both types of income must occur simultaneously. If the S corporation had not realized excluded COD income, the shareholder's suspended losses would have been available to offset the ordinary taxable income. This inequitable result penalizes shareholders simply because the corporation received excluded COD income. Congress could not have intended this result.

suspended loss would have been disallowed as a deduction for each Taxpayer under § 1366(d)(1) and then eliminated through attribute reduction under §§ 108(d)(7)(B) and 108(b).[18] Moreover, attribute reduction is not limited to shareholder losses, and may also include the corporation's basis in property as well under §§ 108(b)(2)(E) and 1017.

2. The *Gitlitz* Court Misread The Plain Language Of § 108(b)(4)(A) To Require Attribute Reduction In The Current Year.

Section 108(b)(4)(A) provides that the tax attribute reduction required by § 108(b)(2) "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge." This means tax attributes can be fully used to reduce tax liability for the year of the discharge. For example, a NOL carried over from the prior year may be used to reduce tax liability in the year of the discharge in an amount unreduced by COD income. It is the NOL, if any, left over *after* the tax computation for the year of the discharge that is subject to reduction. The statute similarly entitles taxpayers to use shareholder losses in the year of discharge. Those losses that are not allowed in the year of discharge are subject to reduction as of the beginning of the following year.

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[18] The Sixth Circuit in *Gaudiano* was persuaded by the Commissioner that, if attribute reduction occurred in the subsequent year, there would be no income remaining at the corporate level to apply against tax attributes. *Gaudiano*, 2000 WL 748179 at *10. This analysis is incorrect. Section 108(d)(7)(B) provides that disallowed losses under § 1366(d)(1) and/or other attributes must be reduced, irrespective of whether excluded COD income passes through to shareholders.

The Third Circuit in *Farley* concurred with the Tenth Circuit's conclusion that the timing rule of § 108(b)(4)(A) was dispositive of the case. *Farley*, 202 F.3d at 205-206. The *Farley* court, however, held that the plain language of the statute mandated a different result:

> The language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year following the year of discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straightforward. . . . Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholder's S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally the tax attribute reduction required by section 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by section 108(b)(4)(A).
>
> We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable year of the discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by

> section 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1).

Farley, 202 F.3d at 205-206.[19] *See also Pugh*, 2000 WL 718215 at *5-6.

Congress understood that attribute reduction was to be postponed until after the full computation of the current year's tax liability. The Senate Report explained that § 108(b) provides that both the current year's loss and any NOL carryover to that year are potentially subject to reduction by excluded COD income, but added that "[t]hese reductions are made after the computation of the current year's tax period." S. Rep. No. 1035, 96th Cong., 2d Sess. 13 (1980), 1980-2 C.B. 620, 626 n.13. Congress unquestionably intended taxpayers to have the use of NOLs during the year of the discharge, with the proviso that any amount unused would be subject to reduction.

Congress's intention that attribute reduction occur in the subsequent taxable year is confirmed by its enactment in 1980 of § 1017, contemporaneous with the enactment of § 108(b)(4)(A). Section 1017 is another part of the insolvency taxation regime. This section governs attribute reduction with respect to basis in assets, one of the other "tax attributes" listed in § 108(b)(2). Prior to its amendment in 1980, § 1017 required that a taxpayer reduce his

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[19] The Seventh Circuit in *Witzel* reached its conclusion that COD income was offset by attribute reduction in the year of discharge, without explicit consideration of the § 108(b)(4)(A) timing rule. *Witzel*, 200 F.3d at 497. The Sixth Circuit in *Gaudiano* concluded that the *Gitlitz* court had correctly decided the timing rule. *Gaudiano*, 2000 WL 748179, at *10.

or her basis in assets by the amount of excluded COD income *during* the taxable year of the discharge.[20] As part of the Bankruptcy Tax Act and simultaneous with the addition of § 108(b)(4), § 1017(a) was amended to provide that if a reduction in property basis is required as part of attribute reduction, the reduction "shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year *following* the taxable year in which the discharge occurs." (Emphasis supplied.) Under § 1017, when a taxpayer sells an asset with a $100 basis during the year of discharge for $100, and also has $100 COD income, the asset basis will not be reduced by the COD income and the taxpayer will report no gain on the sale. However, if the taxpayer instead sold the asset in the year after the discharge, and the property's basis was reduced in attribute reduction, the taxpayer's basis would have been lower at the time of sale, producing gain recognition and tax liability in that year.[21]

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[20] Prior to amendment in 1980, § 108 provided a much more limited exclusion for COD income, specifically conditioned upon the taxpayer's affirmative election to reduce his basis in accordance with § 1017. § 108 (1979), amended by 94 Stat. 3389 (1980). The pre-1980 version of § 1017 stated that where COD income was excluded under § 108, the taxpayer's basis in property owned at the beginning of or at any time during the taxable year of the discharge would be reduced "as of the first day of the taxable year in which the discharge occurred." § 1017 (1979), amended by 94 Stat. 3389 (1980).

[21] Section 108(b)(5) allows taxpayers to elect to have reduction in asset basis under §§ 108(b)(2)(E) and 1017 occur in lieu of other attribute reduction. Under § 1017, such reduction takes place the first day of the following year. The Tenth Circuit's reasoning, which requires attribute reduction in the year of discharge ("absorbing" COD income in the reduction of tax attributes), allows taxpayers who have both corporate basis

The Tenth Circuit's holding in *Gitlitz* denies the shareholder with excluded COD income and suspended losses equal treatment with the shareholder who has excluded COD income and whose corporation has basis in assets. The latter can have his corporation sell assets in the year of the discharge and obtain the benefit of a lower gain passthrough (because of the higher basis) in his computation of tax, but the former cannot obtain any benefit from her suspended losses, even in the year of the discharge.

Congress clearly intended that the attribute reduction rules under §§ 108(b)(4)(A) and 1017 be consistent. The *Gitlitz* opinion artificially and inappropriately frustrates Congress's intent by bifurcating attribute reduction into two separate years: the year of the discharge for most attributes and the following year for basis in assets. This is a perverse and indefensible result.

In an attempt to explain what the language "after the determination of tax for the taxable year" meant, if it did not include basis computations, the Tenth Circuit, citing no authority, held that the "determination of tax" referenced in § 108(b)(4)(A) was limited to "certain tax applications," such as the computation of charitable

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in assets and suspended losses to elect, under § 108(b)(5), to have some or all of the attribute reduction (basis in property) occur in a different year from the §§ 1366 and 1367 passthrough. This would mean that, where taxpayers made the § 108(b)(5) election, excluded COD income would be added to stock basis in the year of the discharge and would not be "absorbed" in the attribute reduction process, because attribute reduction with respect to basis in property would not occur until the following year. Such electing taxpayers would be allowed a basis increase and be permitted to make use of suspended losses during the year of the discharge, unlike their non-electing counterparts.

contribution amounts. This interpretation cannot be reconciled with the language of the statutes.

Section 108(b)(4)(A) cannot be interpreted as requiring initial computations that are part and parcel of the calculation of tax liability for the year be made by taking tax attributes into account, while at the same time, requiring final computation to be made without them.[22] The statute provides no hint that such a result was intended by Congress. Nor is there any principled way of differentiating those computations that include tax attributes from those that do not.

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[22] For example, under § 170, an individual's charitable contribution deduction is limited to a percentage of adjusted gross income (AGI). § 170(b)(1)(F). AGI, however, includes NOL carryforwards from prior years. Consider the situation where a taxpayer with an NOL carryforward of $100 realized $100 of excluded COD income during the taxable year, and also made a charitable contribution during that year. The taxpayer must compute his or her AGI for purposes of determining the allowable charitable contribution amount. Using the *Gitlitz* court's interpretation of § 108(b)(4)(A), the taxpayer must first include the NOL carryforward because COD income would not be applied to "eliminate" the NOL for purposes of calculation of the charitable deduction. This low AGI would serve to limit the charitable contribution deduction for the year, but the taxpayer would then have to make a second computation to determine his or her ultimate tax liability for the year. In the second computation, the taxpayer could not use the $100 NOL because it was a tax attribute subject to reduction. Under the Tenth Circuit's analysis, the taxpayer would pay twice for the COD income exclusion: the charitable contribution deduction would be limited as if there were an NOL lowering his or her AGI, yet the final tax liability would be calculated without the benefit of the NOL attribute.

Other courts that have considered the time for attribute reduction under § 108(b)(4)(A), outside of the S corporation context, have uniformly held that attribute reduction is not made until after the tax liability for the year is computed. In *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 103 T.C. 398 (1994), *aff'd per curiam, adopting the opinion of the Tax Court*, 62 F.3d 136 (5th Cir. 1995), the Tax Court and the Fifth Circuit considered the application of the attribute reduction rules in the consolidated return setting, and held that tax attribute reduction under § 108(b)(4) does not occur "until the next taxable year." *CSI Hydrostatic Testers*, 103 T.C. at 414-415.[23]

Virtually all of the commentators who have considered the issue, including the highly regarded Collier on Bankruptcy Taxation, have concluded that the timing rule of § 108(b)(4) requires the reduction in attributes as of the beginning of the subsequent taxable year. MYRON M. SHEINFELD, FRED T. WITT, JR. & MILTON B. HYMAN, 15 COLLIER ON BANKRUPTCY TAXATION, ¶ 6.03[4][b][i], at 6-103 (Matthew Bender, 1999); Fred T. Witt, Jr., *Report of the [ABA] Section 108 Real Estate and Partnership Task Force*, 46 TAX LAW. 209, 234 (1992); Lisa M. Hebenstreit, *Tying Together the Tax and Bankruptcy Codes*, 54 OHIO ST. L.J. 859, 889 n.21 (1993); and TAX MANAGEMENT PORTFOLIO 731: *S Corporation Operations*, § III.B.1.a at note 414.2 (1999).[24]

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[23] Similarly, in *Kahle v. Commissioner*, T.C.M. (RIA) 97,091, the Tax Court held that, under § 108(b)(4), the taxpayer estate "may use the tax attributes to determine its tax liability for the year of discharge, after which the tax attributes are reduced by the estate under section 108(b)(2). . . . "

[24] The sole authority cited by the *Gitlitz* court in support of its conclusion regarding the timing of attribute reduction is a treatise, C. RICHARD MCQUEEN & JACK F. WILLIAMS, TAX ASPECTS OF

E. The Position That COD Income Is "Tax Deferred" Income Rather Than "Tax-Exempt" Is Incorrect.

The Commissioner has strenuously argued that excluded COD income is not "tax-exempt," but "tax deferred." The Commissioner apparently reasons that if excluded COD income were considered "tax-exempt income," as described in § 1366(a)(1)(A), then it would have to be "taken into account" by shareholders and would result in basis adjustments. The Tax Court agreed with this argument in *Nelson*.

As to the significance of this argument to the ultimate issue, the Third Circuit stated succinctly in *Farley*:

> However, this disagreement between the Government and the Farleys as to the nature of discharge of indebtedness income has little relevance. . . .
>
> The statute is clear – all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation pursuant to section 1366(a)(1)(A).

Farley, 202 F.3d at 210.

1. Excluded COD Income Is Not "Tax Deferred" Income.

Even if the classification of COD income as "tax deferred," as opposed to "tax-exempt," were considered

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BANKRUPTCY LAW AND PRACTICE, § 25:6, at 25-6 (3d ed. 1997). In a discussion of § 1398 (which coordinates the transfer of tax attributes between individual taxpayers in Chapter 11 and their bankruptcy estates), the treatise states, without analysis, that § 108(b)(4) provides "that tax attribute reduction must be made for the taxable year of the discharge."

significant, the application of the "tax deferred" characterization to excluded COD income does not withstand scrutiny.

First, and foremost, no statutory language supports this characterization. Neither the statute nor the regulations use the term "tax deferred."

Second, the Commissioner's contention that income excluded under § 108(a)(1)(B) is not "permanently exempt" because it is linked to attribute reduction ignores reality. Many taxpayers (1) have no tax attributes to reduce, (2) have COD income in excess of their tax attributes, or (3) have attributes to reduce, but the reduction never results in income recognition. *See Farley*, 202 F.3d at 210 (government concedes COD income is "sometimes" tax-exempt). In these instances, the § 108 exclusion will never result in any offsetting future increase in tax.

Although excluded COD income may be effectively "tax deferred" in some circumstances, i.e., dollar for dollar attribute reduction causes additional taxes to be paid in later years, this result does not mean that excluded COD income can always be considered "tax deferred." As the *Farley* court explained:

> Ultimately, the Government argues that since discharge of indebtedness income is sometimes deferred, it should always be considered tax deferred income. This argument suffers from one critical weakness – as the Government concedes, discharge of indebtedness income is sometimes tax exempt. If discharge of indebtedness income is sometimes tax-exempt income and sometimes tax deferred income, it is hard to see how the Government concludes, without more support for its position, that discharge of

> indebtedness income is simply tax-deferred income.

Farley, 202 F.3d at 210.

2. Excluded COD Income Is "Tax-Exempt" Income.

In an effort to avoid the inclusion of excluded COD income within the parenthetical of § 1366(a)(1)(A) as "tax-exempt income," the Commissioner has sought to differentiate income excluded under § 108 from income excluded under the other exclusions under Part III of Subtitle A of the Code. This is a difficult task because each of these provisions contains the same operative language: "gross income does not include. . . . " Moreover, the Commissioner's efforts in this regard are hampered by the fact that substantial prior usage of the term "exempt" in the Code and in Treasury Regulations belies the distinction that the Commissioner advances.

In the regulations governing the allocation and apportionment of deductions to income earned from domestic and foreign sources, Treasury has construed the phrase "exempt income" broadly to include all income which is "exempt, excluded or eliminated" for federal income tax purposes. Temp. Treas. Reg. § 1.861-8T(d)(2)(ii)(A). Treasury recognized that the ordinary, everyday meaning of the word "exempt" is "not subject to tax" and is synonymous with the term "excluded."

Section 139 uses the term "exemption" as a generic description of the exclusions in Part III (§§ 101-139). Section 139 is a cross-reference statute whose operative language provides that "for ***exemption*** of" certain items from income, a designated section of another Title should

be consulted.[25] Congress thus considered the statutes found in Part III to be, as a group, "exemptions" from tax, and, indeed, used the term "exemption" as a synonym for "exclusion."

In addition, the Consolidated Return Regulation governing parent basis in subsidiaries (which is similar to the rules for shareholder basis in S corporations) provides for a basis increase for tax-exempt income. Treas. Reg. § 1.1502-32(b)(2)(ii). The regulations treat substituted basis transactions (where recognition is deferred until a replacement asset is sold at a later date, e.g., §§ 118, 332, 351, and 1031) as not "tax-exempt." Treas. Reg. § 1.1502-32(b)(3)(ii)(A). However, the regulations explicitly characterize excluded COD income as a species of "tax-exempt income," which increases basis. Treas. Reg. § 1.1502-32(b)(3)(ii)(C)(1).[26]

Finally, in the case of partnerships, the passthrough entity on which S corporations were modeled, a partner's interest is increased by both the taxable income of the partnership and "income of the partnership exempt from tax under this title." § 705(a)(1).[27] Recently, the IRS issued

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[25] During 1991, the identical cross-reference statute was found at § 136.

[26] The regulation provides a special rule limiting the basis increase for excluded COD income, only allowing the increase to the extent of attribute reduction.

[27] When Congress adopted the partnership basis rules (upon which the Subchapter S rules are modeled), it described the rationale for adjusting a partner's interest for nontaxable income as follows:

> [A] partner's share of nontaxable income (such as exempt income or depletion allowances in excess of basis) is added to the basis of his interest in the

a Technical Advice Memorandum indicating that when a partnership receives COD income, a partner's pro rata share of that income increases that partner's basis, irrespective of whether that income is taxable or tax-exempt to the partner and irrespective of the fact that attributes may be reduced because of the COD income inclusion. Tech. Adv. Mem. 97-39-002 (September 26, 1997).[28] The TAM quoted extensively from the legislative history of § 108 and concluded that income excluded from tax under § 108(a) *does* increase basis under § 705 (the partnership analogue of § 1367), even though tax attributes may be reduced.

Given this prior substantial characterization of all excluded income, including COD income, as "tax-exempt," the Government's attempt to manufacture a metaphysical difference between "exclusion" and

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> partnership so that the benefit of such tax-exempt income will not be lost to the partner. Otherwise, a partner would eventually incur a capital gain with respect to such amounts. Similarly, the partner's share of nondeductible expenditures must be deducted from basis in order to prevent such amounts from eventually constituting capital loss to him.

S. Rep. No. 1622, 83rd Cong., 2d Sess. 384 (1954), 1954 WL 6064 (Leg.Hist.) at *953, 1954 U.S.C.C.A.N. 4261.

[28] While this Technical Advice Memorandum is not official precedent under § 6110(k)(3), such rulings may be cited for the purpose of providing evidence of the Commissioner's interpretation (*Cantebury v. Commissioner*, 99 T.C. 223, 247 (1992) (*quoting Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962))), insight into the Commissioner's understanding of complex tax issues (*Capitol Fed. S & L Assoc. v. Commissioner*, 96 T.C. 204, 223 (1991)), or evidence of confusion in the Commissioner's interpretation or a change in position. (*Spencer v. Commissioner*, 43 F.3d 226, 234 (6th Cir. 1995)).

"exemption" linked to a potential reduction of attributes must be rejected.

F. Following The Statutory Scheme Merely Provides The Taxpayers With Benefits Afforded All Other Recipients Of Nontaxable Income – This Cannot Fairly Be Characterized As A Windfall.

Throughout the history of this litigation, the Commissioner has endeavored to advance a fundamental misconception: that permitting a shareholder stock basis increase for excluded COD income results in an unwarranted "windfall" to the shareholder. With that premise, despite having a position that ignores the language of the statutes and the regulations, the Commissioner convinced the Tax Court and the Tenth Circuit to construe the applicable statutes in such a manner so as to avoid the perceived windfall. The Tenth Circuit believed that permitting a taxpayer to exclude the income on one hand, and then to also obtain the benefit of a basis increase that permitted the use of additional losses, constituted "the equivalent of a double deduction." *Gitlitz*, 182 F.3d at 1147-1148.

However, there is *no* windfall if S corporation shareholders whose corporations realize excluded COD income only receive a benefit, which the statutes afford to all similarly situated taxpayers. Indeed, the Commissioner's position deprives some S corporation shareholders of benefits the Commissioner agrees are available to others. For example, the Commissioner does not dispute that when an S corporation realizes tax-free bond interest, the interest income passes through to the shareholders and increases their basis under §§ 1366 and 1367. The shareholder receives both an exemption from tax, as

well as an addition to basis that permits the use of suspended losses.[29] The "double benefit" abhorred by the Tenth Circuit is freely available to recipients of all items of nontaxable income.

Economically, the insolvent S corporation that receives the discharge of a liability is in exactly the same position as the insolvent S corporation that receives tax-exempt interest income. The first corporation's balance sheet is adjusted by the amount of the discharge (reduction in liabilities) just as surely as the balance sheet of the second corporation is adjusted by the tax-exempt interest (increase in assets). Unless a basis increase is made, the difference in net equity due to the discharge of debt could be subject to tax at the shareholder level by reason of a distribution of corporate assets to the shareholder, or upon the disposition of his or her stock in the corporation.

The Tenth Circuit reasoned that another tax policy reason for denying the Taxpayers a basis increase was the lack of any "economic outlay" associated with the receipt of COD income. *Gitlitz*, 182 F.3d at 1151. No valid rationale exists for denying the Taxpayers a basis increase on the grounds that excluded COD income was not obtained through an "economic outlay." *Farley*, 202 F.3d at 207 n.5; *Pugh*, 2000 WL 718215 at *6. Exempt COD income cannot be meaningfully differentiated from other forms of nontaxable income on the basis of economic outlay. Consider

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[29] If they had taken steps to protect their interests, the insolvent corporation's other creditors may have required that the corporation pledge the tax-exempt instrument, and required that proceeds from the corporation's investment be paid to them. Thus, distribution of tax-exempt income may not even be an option.

the corporation that collects on a $1 million life insurance policy on its officer, having paid $5,000 in premiums. The $995,000 in income is excludable under § 101, and increases shareholder basis. This situation is indistinguishable from the corporation that pays $5,000 in fees to obtain a $1 million loan that is later forgiven. While these two examples involve the same "economic outlay," the fact is that the shareholder basis increase for corporate income under §§ 1366(a)(1)(A) and 1367(a) is not conditioned upon any prior economic outlay.

The Commissioner's position in effect treats excluded COD income just as if it were fully taxable income and not subject to an exclusion under § 108. If the COD income had been taxable income, the Taxpayers would have increased their basis by the amount of the COD income. Suspended losses would then have been freed up, offsetting the taxable income and reducing the Taxpayers' basis under § 1367(a)(2)(B). The Taxpayers would have paid no tax, but would have had no suspended losses left at the end of the day. This is exactly the same position the Commissioner places the Taxpayers, although the Taxpayers are entitled to receive the benefit of an exclusion from tax. To avoid a perceived "windfall," the Tax Court and the Tenth Circuit unfairly denied any benefit flowing from the § 108(a) exclusion. Under the Commissioner's reasoning, the excluded COD income would be treated no differently than taxable COD income.

VII. CONCLUSION

The stock basis increases and loss deductions claimed by the Taxpayers are not only required by the language of the controlling statutes, but they are in accordance with

the purpose of the statutes as well. If a distinction is to be drawn between COD income and other forms of non-taxable income for purposes of determining shareholder basis, the distinction must be implemented through legislative action, not judicial amendment to carefully crafted rules.

Respectfully submitted this 29th day of June, 2000.

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26 C.F.R. § 1.1367-1

Sec. 1.1367-1 Adjustments to basis of shareholder's stock in an S corporation.

(a) In general – (1) Adjustments under section 1367. This section provides rules relating to adjustments required by section 1367 to the basis of a shareholder's stock in an S corporation. Paragraph (b) of this section provides rules concerning increases in the basis of a shareholder's stock, and paragraph (c) of this section provides rules concerning decreases in the basis of a shareholder's stock.

(2) Applicability of other Internal Revenue Code provisions. In addition to the adjustments required by section 1367 and this section, the basis of stock is determined or adjusted under other applicable provisions of the Internal Revenue Code.

(b) Increase in basis of stock – (1) In general. Except as provided in Sec. 1.1367-2(c) (relating to restoration of basis of indebtedness to the shareholder), the basis of a shareholder's stock in an S corporation is increased by the sum of the items described in section 1367(a)(1). The increase in basis described in section 1367(a)(1)(C) for the excess of the deduction for depletion over the basis of the property subject to depletion does not include the depletion deduction attributable to oil or gas property. See section 613(A)(c)(11).

(2) Amount of increase in basis of individual shares. The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of

the items described in section 1367(a)(1) that is attributable to that share, determined on a per share, per day basis in accordance with section 1377(a).

(c) Decrease in basis of stock – (1) In general. The basis of a shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the items described in section 1367(a)(2).

(2) Noncapital, nondeductible expenses. For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (noncapital, nondeductible expenses) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: Illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162.

(3) Amount of decrease in basis of individual shares. The basis of a shareholder's share of stock is decreased by an amount equal to the shareholder's pro rata portion of the passthrough items and distributions described in section 1367(a)(2) attributable to that share, determined on a per share, per day basis in accordance

with section 1377(a). If the amount attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares.

(d) Time at which adjustments to basis of stock are effective – (1) In general. The adjustments described in section 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, if a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.

(2) Adjustment for nontaxable item. An adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for Federal income tax purposes if the item had been subject to Federal income taxation.

(3) Effect of election under section 1377(a)(2) or Sec. 1.1368-1(g)(2). If an election under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under Sec. 1.1368-1(g)(2) (to terminate the year in the case of a qualifying disposition) is made with respect to the taxable year of a corporation, this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which either the shareholder's interest

is terminated or a qualifying disposition occurs, whichever the case may be.

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